

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-77875; File No. SR-ISE-2016-08)

May 20, 2016

Self-Regulatory Organizations; International Securities Exchange, LLC; Order Approving
Proposed Rule Change Related to Market Wide Risk Protection

I. Introduction

On March 17, 2016, the International Securities Exchange, LLC (the “Exchange” or “ISE”) filed with the Securities and Exchange Commission (“Commission”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to introduce new activity-based risk protection functionality. The proposed rule change was published for comment in the Federal Register on April 6, 2016.³ No comment letters were received in response to this proposal. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange proposed to introduce two activity-based risk protection measures that will be mandatory for all members: (1) the “Order Entry Rate Protection,” which prevents members from entering orders at a rate that exceeds predefined thresholds,⁴ and (2) the “Order Execution Rate Protection,” which prevents members from executing orders at a rate that exceeds their predefined risk settings (together, “Market Wide Risk Protection”). The Exchange will

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 77489 (Mar. 31, 2016), 81 FR 20004 (“Notice”).

⁴ The Exchange stated that it will initiate the Order Entry Rate Protection pre-open, but in a manner that allows members time to load their orders without inadvertently triggering the protection. The Exchange further noted that it will establish and communicate the precise initiation time via circular and prior to implementation. See Notice, supra note 3, at 20004 n.4.

announce the implementation date of the proposed rule in a circular to be distributed to members prior to implementation.⁵

Pursuant to proposed Rule 714(d), “Market Wide Risk Protection,” the Exchange’s trading system (the “System”) will maintain one or more counting programs on behalf of each member that will track the number of orders entered and the number of contracts traded on ISE or, if chosen by the member, across both ISE and its affiliate, ISE Gemini, LLC (“ISE Gemini”).⁶ Members may also use multiple counting programs to separate risk protections for different groups established within the member.⁷ The counting programs will maintain separate counts, over rolling time periods specified by the member, for each count of: (1) the total number of orders entered in the regular order book; (2) the total number of orders entered in the complex order book with only options legs; (3) the total number of orders entered in the complex order book with both stock and options legs; (4) the total number of contracts traded in regular orders; and (5) the total number of contracts traded in complex orders with only options legs.⁸

According to the Exchange, members will have the discretion to establish the applicable time period for each of the counts maintained under the Market Wide Risk Protection, provided that the selected period is within minimum and maximum time parameters that will be

⁵ See Notice, supra note 3, at 20004.

⁶ Members may set different risk parameters for their trading activity on each exchange, or they may set risk parameters that apply to their trading across both ISE and ISE Gemini. See proposed Rule 714(d).

⁷ The Exchange stated that it will explain how members can go about setting up risk protections for different groups (e.g., business units) in a circular issued to members. See Notice, supra note 3, at 20004-05 n.7.

⁸ See proposed Rule 714(d). The Exchange clarified that a member’s allowable order rate for the Order Entry Rate Protection will be comprised of parameters (1) to (3), while the allowable contract execution rate for the Order Execution Rate Protection will be comprised of parameters (4) and (5). The Exchange further explained that contracts executed on the agency and contra-side of a two-sided crossing order will be counted separately for the Order Execution Rate Protection. See Notice, supra note 3, at 20005.

established by the Exchange and announced via circular.⁹ By contrast, the Exchange's proposal does not establish minimum or maximum values for any of the order entry or execution parameters described in (1) through (5) above. Nevertheless, the Exchange will establish default values¹⁰ for the time period, order entry, and contracts traded parameters in a circular to be distributed to members. The Exchange represented that such default values will apply only to members that do not submit their own parameters for the Market Wide Risk Protection measures.¹¹

The Exchange further proposed to use separate counts for regular orders, complex options orders,¹² and complex orders with a stock component,¹³ as it believed that members may want to have different risk settings for these instruments. If the Market Wide Risk Protection is triggered based on any count, however, proposed Rule 714(d) states that the triggered action (discussed below) will be taken across the entire market – with respect to all products traded in both simple and complex instruments and across ISE (or, if set by the member, across ISE and ISE Gemini).¹⁴

⁹ Id. The Exchange stated that it anticipated setting these minimum and maximum time parameters at one second and a full trading day, respectively. See Notice, supra note 3, at 20005 n.9.

¹⁰ See proposed Rule 714(d); see also Notice, supra note 3, at 20005.

¹¹ Id.

¹² The Exchange explained that the contract execution count for complex orders with only options legs will be the sum of the number of contracts executed with respect to each leg. Id.

¹³ Complex orders that contain a stock component will not be included as part of the complex order execution count. The Exchange stated its belief that the separate components of stock-option orders (i.e., options components executed in contracts and stock components executed in shares) could not be combined in a way that would provide a meaningful measure of risk exposure. See Notice, supra note 3, at 20005 n.10.

¹⁴ Proposed Rule 714(d)(1); see also Notice, supra note 3, at 20005.

Under proposed Rule 714(d), the System will trigger the Market Wide Risk Protection when it determines that the member has either (1) entered a number of orders exceeding its designated allowable order rate for the specified time period, or (2) executed a number of contracts exceeding its designated allowable contract execution rate for the specified time period.¹⁵ If the member's thresholds have been exceeded in either simple or complex instruments, the Market Wide Risk Protection will be triggered and the System will automatically reject all subsequent incoming orders entered by the member on ISE or, if set by the member, across both ISE and ISE Gemini.¹⁶ In addition, if the member has opted in to this functionality, the System will automatically cancel all of the member's existing orders.¹⁷ The Market Wide Risk Protection will remain engaged until the member manually (e.g., via e-mail) notifies the Exchange to enable the acceptance of new orders.¹⁸

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of Section 6 of the Act¹⁹ and rules and regulations thereunder applicable to

¹⁵ Id.; see also proposed Rule 714(d)(1). Specifically, after a member enters or executes an order, the System will look back over the specified time period to determine whether the member has exceeded the relevant thresholds. See Notice, supra note 3, at 20005. In the Notice, the Exchange provided examples illustrating how the Market Wide Risk Protection functionality would work both for order entry and order execution protections. See Notice, supra note 3, at 20005-06.

¹⁶ According to the Exchange, members that set different risk parameters for ISE and ISE Gemini will only have their orders rejected on the exchange whose threshold was exceeded. See Notice, supra note 3, at 20005 n.11.

¹⁷ Proposed Rule 714(d)(2).

¹⁸ Proposed Rule 714(d)(3). Members who have not opted to cancel all existing orders under proposed Rule 714(d)(2), however, will still be able to interact with their existing orders entered before the Market Wide Risk Protection was triggered. For instance, such members may send cancel order messages and/or receive trade executions for those orders. Id.; see also Notice, supra note 3, at 20005.

¹⁹ 15 U.S.C. 78f(b).

a national securities exchange.²⁰ In particular, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest.²¹

The Commission believes that the Exchange's proposed activity-based order protections will provide an additional tool to members to assist them in managing their risk exposure.²² Specifically, the Commission believes that the Market Wide Risk Protection functionality may help members to mitigate the potential risks associated with entering and/or executing a level of orders that exceeds their risk management thresholds that may result from, for example, technology issues with electronic trading systems. Further, the Commission notes that other exchanges have established risk protection mechanisms for members and market makers that are similar in many respects to ISE's proposal.²³

Proposed Rule 714(d) imposes a mandatory obligation on ISE members to utilize the Market Wide Risk Protection functionality. The Commission notes that, although the Exchange will establish minimum and maximum permissible parameters for the time period values, members will have discretion to set the threshold values for the order entry and order execution

²⁰ In approving these proposed rule changes, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²¹ 15 U.S.C. 78f(b)(5).

²² The Exchange currently provides members with limit order price protections that reject orders priced too far outside of the Exchange's best bid or offer. See ISE Rule 714(b)(2).

²³ See, e.g., Miami International Securities Exchange, LLC Rule 519A ("Risk Protection Monitor"); BATS BZX Exchange, Inc. Rule 21.16 ("Risk Monitor Mechanism").

parameters.²⁴ If members do not independently set such parameters, they will be subject to the default parameters established by ISE.²⁵ While the Commission believes that the Exchange's proposed rule provides members flexibility to tailor the Market Wide Risk Protection to their respective risk management needs, the Commission reminds members to be mindful of their obligations to, among other things, seek best execution of orders they handle on an agency basis and consider their best execution obligations when establishing parameters for the Market Wide Risk Protection or utilizing the default parameters set by ISE.²⁶ For example, an abnormally low order entry parameter, set over an abnormally long specified time period should be carefully scrutinized, particularly if a member's order flow to ISE contains agency orders. To the extent that a member chooses sensitive parameters, a member should consider the effect of its chosen settings on its ability to receive a timely execution on marketable agency orders that it sends to ISE in various market conditions. The Commission cautions brokers considering their best execution obligations to be aware that the agency orders they represent may be rejected as a result of the Market Wide Risk Protection functionality.

As discussed above, ISE determined not to establish minimum and maximum permissible settings for the order entry and order execution parameters in its rule and indicated its intent to set a minimum and maximum for the time period parameters that provide broad discretion to

²⁴ The Exchange has represented that it anticipates that the minimum and maximum values for the applicable time period will be initially set at one second and a full trading day, respectively, which the Commission believes gives members wide latitude in establishing the applicable time periods. See Notice, supra note 3, at 20005 n.9.

²⁵ Proposed Rule 714(d).

²⁶ See Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290, at 48323 (Sept. 12, 1996) (Order Execution Obligations adopting release); see also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37537–8 (June 29, 2005) (Regulation NMS adopting release).

members (i.e., one second and a full trading day, respectively).²⁷ In light of these broad limits, the Commission expects ISE to periodically assess whether the Market Wide Risk Protection measures are operating in a manner that is consistent with the promotion of fair and orderly markets, including whether the default values and minimum and maximum permissible parameters for the applicable time period established by ISE continue to be appropriate and operate in a manner consistent with the Act and the rules thereunder.

Finally, the Commission believes that it is consistent with the Act for ISE to offer its Market Wide Risk Protection across both ISE and its affiliate, ISE Gemini, as such functionality could assist members in managing and reducing inadvertent exposure to excessive risk across both of these markets if the member desires to avail itself of that feature. Further, the Commission notes that it previously approved ISE's proposal to offer cross-market risk protections for market maker quotes, and approval of the cross-market application of the Market Wide Risk Protection functionality is consistent with that prior approval.²⁸

²⁷ See Notice, supra note 3, at 20005 n.9; see also supra note 24.

²⁸ See ISE Rule 804(g); see also Securities Exchange Act Release No. 73147 (Sept. 19, 2014), 79 FR 57639 (Sept. 25, 2014) (SR-ISE-2014-09) (approval order).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁹ that the proposed rule change (SR-ISE-2016-08) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁰

Robert W. Errett
Deputy Secretary

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).